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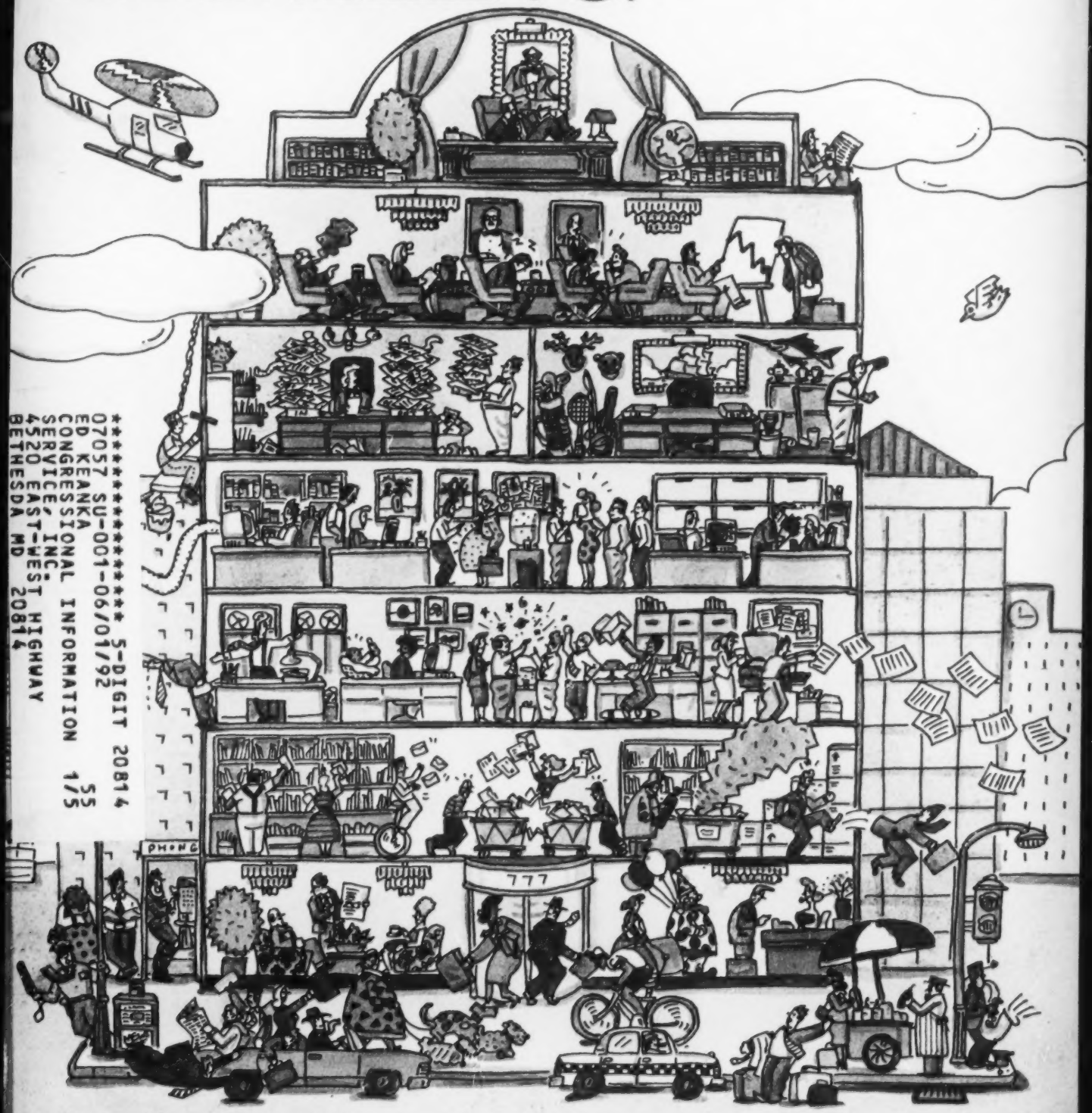
SEPTEMBER 1990

MORTGAGE BANKING

THE MAGAZINE OF REAL ESTATE FINANCE



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THE ANATOMY of the BUSINESS

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SEPTEMBER 1990 VOLUME 50 NUMBER 12

COVER:
Internal Management

If you look inside a mortgage company, it looks like almost any other workplace. Who would guess that what is being manufactured is the stuff of dreams. Getting people into houses does not require heavy machinery or robotics on an assembly line. Instead, it is people that move those dreams through the pipeline and deliver them into the mainstream of everyday life.

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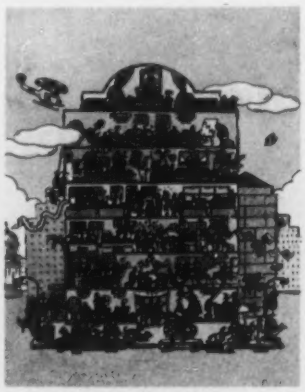
COVER ILLUSTRATION BY WANGDON LEE

The Backbone

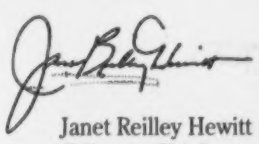
People are the backbone of the mortgage business—both people seeking a new home and people laboring to provide the money to buy it. That's a nice homey observation about the raw materials that drive the business, but it doesn't really say much more.

But, the way people really matter to those charged with running the business is by how efficiently they work. This, after all, remains a profoundly people-intensive way to make a profit—or not. In this issue devoted to examining the basic anatomy of the business, we see how people working harder and smarter can be the cure for what ails those toiling to survive in this industry.



People in the servicing department probably more aptly could be called the very muscle fiber of the operation. How efficiently they work spells the difference between anemic and healthy profits. KPMG Peat Marwick has been doing some basic research on the anatomy of several large servicing operations for four years now. They have sifted through the results just collected for last year and their findings are revealed in our cover story. Their diagnosis confirms that the one thing that separates the flabby servicers from those with peak muscle tone is the output they get from their people. There is just no way around these numbers: the low-cost servicers in their study averaged 919 loans serviced per full-time equivalent (FTE). On the other hand, high-cost servicers averaged a meager 472. Enough said?

This issue serves then as a tribute to those who have managed to create these lean, mean, people machines and to those striving to do so.



Janet Reilley Hewitt
Editor in Chief

EDITOR'S NOTE: In the July 1990 issue of *Mortgage Banking*, in the article titled "Discovering Commercial Mortgage Statistics," Table 1 should have shown the number of nonfarm, nonresidential, permanent mortgages originated in 1989 by savings and loans as 9,596.

COMING IN OCTOBER

The next issue will focus on the permanent structural changes now rocking the mortgage banking business. Our authors will try to size up the outlook for interest rates, appreciation, pricing, competition, servicing prices, budget reduction and profitability trends.

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ILLUSTRATION BY WANGDON LEE

SERVICING'S GREAT DIVIDE

The gap between high- and low-cost servicers remains wide, a new report card on the industry's biggest servicers shows. High-cost servicers suffer from many ailments, one of which is poor productivity.

Linda C. Simmons

This article is the first of a two-part series that examines mortgage servicing through a comprehensive study by KPMG Peat Marwick.

"Happy families are all alike; every unhappy family is unhappy in different ways"

Anna Karenina
Leo Tolstoy

In keeping with Leo Tolstoy's observation about life more than 100 years ago, KPMG Peat Marwick's 1989 Mortgage Servicing Performance Study (MSPS) found the same principles applying to mortgage servicing. The lower cost servicers were low cost for very similar reasons; the higher cost servicers experienced higher costs for very different reasons.

Furthermore, the mixture of results from the study still indicates that opportunities abound when servicers view both cost and profitability factors simultaneously.

For its fourth annual MSPS, KPMG Peat Marwick expanded the study's scope to include the key components of profitability as well as the components of servicing cost. Data collection was expanded in some areas, including portfolio characteristics, investor reporting, collections, foreclosures, and real estate owned (REO) costs. The number of participants grew, resulting in a database comprised of more than two million loans or $116 billion in loans serviced.

Servicing industry leaders from across the country submitted critical 1989 unit-cost and productivity, operating, profitability and balance-sheet data in early March. Stringent validation techniques were applied, and 19 servicing functions were analyzed, along with key portfolio, compensation and profitability statistics. Analytical results were provided to the participants in mid-May. Senior executives of

participating firms met in early June to jointly review the results and to profile operational efficiencies. The information shared during the two days of discussion produced some enlightening insights on the results of the study.

Overall cost results

Core servicing cost, defined as the direct costs tied to each functional area within servicing, averaged $94 per loan. Of the 12 percent increase in the 1988 average core cost, nearly half is attributed to the change in capturing core costs in the REO area to more aptly reflect true costs incurred by servicers who also manage foreclosed property. The lower-cost servicers averaged $57 in core costs per loan, while the higher-cost servicers averaged $140 per loan. The relative distribution of core costs is reflected in Chart 1.

The total servicing cost per loan includes core costs, collateral losses, interest and other expenses resulting from bad loans plus allocated overhead. In contrast to the increase in core costs, the results for total servicing cost remained reasonably stable—averaging $144 versus 1988's average of $149. The contribution to total servicing cost from core costs increased from 56 percent to 65 percent; however, this increase was more than offset by the significant decrease in bad loan losses from 34 percent to 20 percent. A distribution of the different elements contributing to overall servicing costs is depicted in Chart 2.

Cost trends

The study's primary analytical focus was on the 19 servicing functional areas. Some overall, as well as some specific characteristics and patterns

> The most significant cost increase came in the area of collections and foreclosures.

have emerged from the results of the last four years of the study. The following are some specific insights into the mortgage servicing operation derived from the current year's study.

- Once again, loans serviced per full-time equivalent (FTE) proved to be a general predictor of core servicing cost performance. For the lower-cost study participants, loans serviced per FTE averaged 919; that is well above the average of 672 loans per FTE for all the participants in the study. Higher-cost servicers averaged 472 loans per FTE. The majority of repeat participants showed an increase in productivity, averaging 13 percent above their 1988 average.
- Consistent with prior years' studies, the overall size of each participant's portfolio was not a predictor of core servicing costs. The average portfolio size for lower-cost servicers (257,000 loans) did exceed the average portfolio size for all participants in the study in 175,000 loans. However, the higher-cost servicers averaged 166,000 loans in their loan portfolio.
- The most significant cost increase came in the area of collections and foreclosures, which includes bankruptcy and real estate owned functions. These costs rose 29 percent from the 1988 average. Interestingly, the lower-cost participants managed the expense of this key functional area up-front by spending twice as much, and using twice the FTEs in the collections area as in the foreclosure area. Higher-cost servicers spent twice as much on the foreclosure function as on the collections function.
- Overall turnover proved to be a reasonably good predictor of core cost performance. Surprisingly, a very low turnover rate had an adverse effect on core costs. Turnover by functional area was not a good predictor for functional core cost performance.
- While industry analysts have been predicting a growing trend toward servicing consolidation, a minimal amount of consolidation was detected in the 1989 study.

Lower cost vs. higher cost

As noted, lower-cost servicers share some similarities, including:

- a higher concentration of GNMA loans in their portfolios, with GNMA concentrations averaging 46 percent versus 20 percent for the remaining participants;

Chart 1

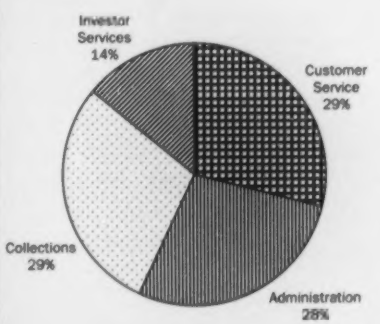


Chart 2

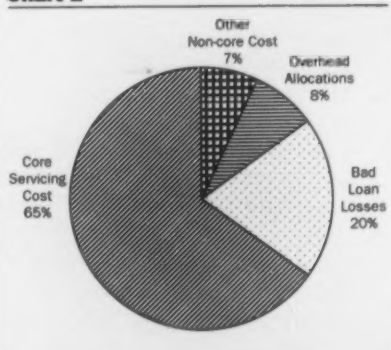
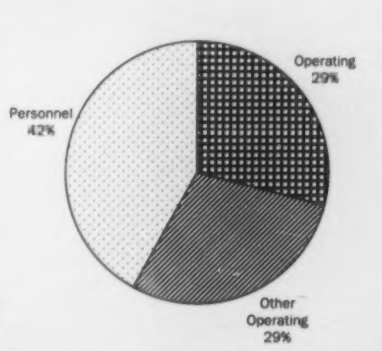


Chart 3



- a higher concentration of fixed-rate loans than the remaining participants, 94 percent versus 79 percent, respectively;
- in general, a larger amount of net growth within each portfolio, whereby the higher-cost servicers experienced little or negative growth; and
- a lower salary cost per FTE. Salary and other personnel costs had a significant impact on overall costs as 40 percent of core costs were personnel costs. (This is depicted in Chart 3.)

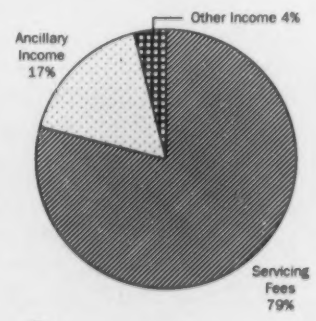
Like Tolstoy's unhappy families, the study's higher cost servicers shared few characteristics. However, certain features did emerge as contributing to the higher costs experienced by these servicers. They included:

- a higher concentration of loans in one or two states that did not provide lower cost opportunities for these servicers;
- use of either monthly billings or coupon books, or both (while lower-cost servicers used coupon books almost exclusively);
- portfolios dominated by conventional fixed-rate, ARM, and GNMA product, respectively for the top three high-cost servicers;
- no confirmed pattern of above-average prepayments, delinquencies or foreclosures;
- somewhat higher salaries per FTE, but more FTEs in general.

The three highest-cost servicers had their portfolios serviced by a service bureau, a modified in-house service bureau, and a custom in-house system indicating no connection that could be automatically linked to higher servicing costs.

One characteristic shared by most higher-cost servicers was a substantial parent company overhead allocation, either in the form of data processing costs or management fees. A larger expense allocation for data processing increased the core servicing cost, while the higher management fees increased the total servicing cost.

Chart 4



> The study for 1989 showed that total servicing revenues averaged 48 basis points on an average loan balance of $64,000.

Profitability trends

The study for 1989 showed that total servicing revenues averaged 48 basis points on an average loan balance of $64,000. As expected, servicing fees dominated the revenue area, accounting for 79 percent of gross revenues. Ancillary income, including late charges, insurance fees, assumption fees, and the like, contributed 17 percent of gross revenues, or $49 per loan. Chart 4 provides a breakout of these servicing-related revenue sources.

There was, however, no clear relationship between revenues generated from servicing and net income. There was also no relationship between gross revenues and core cost performance. Because this was the first year profitability data was collected, we were unable to discern whether this was a continuing trend or not.

Emerging issues

This study is a peer analysis that bases its results on cost comparisons to a comprehensive mortgage servicing performance analysis. It is still evolving, and we encourage management involvement at all levels and areas. The study will continue to focus on current industry concerns including emerging tax issues, and accounting issues involving purchased and excess servicing.

As our understanding of servicing's cost components grows, so does our list of questions. While maintaining the consistency of data is an ongoing challenge, study participants are to be congratulated for their diligence in assisting us in molding their data into comparable form. Perhaps the more difficult part of the study is asking enough questions, particularly in those areas experiencing rising costs or declining profitability. For example, does the increase in the collections and foreclosure cost area complement the decline in industry delinquency and foreclosure rates? Or, does it serve as a predictor of future rising delinquency and foreclosure rates?

In Part II of this article (scheduled to appear in the October issue), we will discuss additional analyses beyond cost performance in an attempt to address some of these issues. Statistically significant relationships, derived from four year's worth of collected data, will help promote a further understanding of servicing performance.

Study participants have used the results of these annual analyses to conduct yearly internal management reviews of their servicing operation and to get an updated view of their servicing department's performance relative to the best in the industry. In the future, study participants will be provided updated information and ongoing analyses to better position their servicing department to take advantage of emerging trends and issues. This data should help other servicing managers share in the solutions and further cultivate ideas that are available from the most successful servicers in the industry. **MB**

Linda C. Simmons is a principal in KPMG Peat Marwick's Washington, D.C. office. Dr. Simmons is an active participant in the firm's national mortgage banking practice. The 1990 Mortgage Servicing Performance Study will be conducted by the Washington office.

ECONOMIC TRENDS

As we enter the 1990s, few would deny that housing conditions in the U.S. are among the best, if not the best, in the world. Still, the decade began with fears about the outlook for new construction, trends in home prices, the viability of financial institutions, and the persistence of affordability problems. Many of these issues are addressed in a new study by the Joint Center for Housing Studies of Harvard University entitled *The State of the Nation's Housing 1990.*

The study begins by addressing the widely recognized impact of demographic changes on housing demand. The baby boom generation—those individuals born between 1946 and 1964—boosted the rate of population growth in the U.S. significantly in the 1950s and early 1960s. Since then, the population growth rate has slowed and is expected to continue to do so in the 1990s. The formation of the population into households, which is very sensitive to the age-distribution of the population, has followed predictable patterns. When the bulk of the baby boomers hit their twenties in the 1970s, household formations soared, and, along with this surge in formations, new construction surged too. In the 1990s, household formations will slow because many baby boomers have already formed households and the subsequent generation is much smaller. Consequently, recognizing that new construction equals the sum of new household formations, changes in the number of vacant units, and replacements of worn-out units, it is clear that the pace of new construction is almost certain to slow.

Table 1 shows the sources of new construction demand. During the 1970s, household formations were so strong that new construction (excluding mobile homes) averaged nearly 1.8 million units per year. As formations slowed, so did the pace of construction activity. In the 1980s, new construction of structures amounted to 1.50 million units per year. In the early 1990s, activity is expected to slow to around 1.37 million units per year; then to drop to around 1.27 million units in the late 1990s.

However, the composition of these units is likely to change. Units are likely to be larger and have more amenities as the baby boomers move up from starter homes. Consequently, construction spending is likely to hold its own in the face of a decreasing number of units. The Joint Center notes: "Market forces point to steady growth of tradeup demand, with increases in the size and quality of new homes built countering declines in the number of units constructed." The implication is that the trend toward the construction of fewer units may not impact mortgage lending volume adversely.

TABLE 1

Sources of New Construction Demand
[Thousands of Units, Annual Averages]

Period	Total New Construction		Sources of Demand		
	Structures	Mobile Homes	Household Formations	Change in Vacancies	Replacement of Worn-out Units
1970-1980	1,786	367	1,604	122	427
1980-1990	1,500	249	1,275	306	168
1990-1995	1,371	200	1,223	126	222
1995-2000	1,269	200	1,090	144	235

Source: Joint Center for Housing Studies, Harvard University

The Joint Center also finds no evidence to support the claim that reduced demographic demand will result in falling home prices, as some have predicted. The study concludes: "...Housing prices are unlikely to ease during the 1990s....Today's homeowners have little reason to worry." Further, because homes are generally highly leveraged (i.e., homeowners borrow to cover most of the purchase price), the study demonstrates that homeownership remains one of the best vehicles for wealth accumulation and financial security for most households. Continued modest home price appreciation will ensure this role continues into the 1990s.

Unfortunately, affordability problems remain. Those who are not homeowners currently face the difficulty of overcoming cumulative price increases in the 1970s and much of the 1980s that drove home prices to levels beyond the means of most renters. Because homeownership is so vital to wealth accumulation, locked-out would-be buyers face a dilemma. The Joint Center notes: "This is the vicious circle would-be buyers face: lack of savings and wealth prevent them from securing a home, the very asset that has proven to be the best source of wealth accumulation for the vast majority of American households." Because home prices are not likely to decline, the Joint Center argues that "there is little reason to believe that the affordability problems of the past two decades will quickly fade away in the 1990s."

The study suggests that only 13.6 percent of the 29 million renters nationwide could qualify for a mortgage to buy a typical starter home. Further, of the 11 million young renter households—defined as households headed by individuals aged 25 to 34—only 12 percent had both adequate savings to make the necessary down payment on a typical starter home and the income to meet mortgage payments. The down payment was clearly the bigger problem. Fully 81 percent of these households could not meet the down payment requirement. In short, the Joint Center study makes it clear that housing affordability remains a major obstacle to homeownership in the U.S.

Thomas M. Holloway
Senior Economist

VITAL STATISTICS

INTEREST RATES & YIELDS
1- TO 4-FAMILY MORTGAGES

	FHA OPINION SURVEY	FHFB			FNMA		FHLMC	
		CONVENTIONAL[2]						
1990	FHA New Homes[1]	FRM	ARM	Median Cost of Funds FSLIC Institutions	1-Yr. ARM	FRM Conv.	ARMs	FRMs
APR	10.53%	10.50%	9.21%	NA	8.60%	10.37%	8.55%	10.37%
MAY	10.49	10.54	9.26	NA	8.45	10.29	8.59	10.48
JUN	10.21	10.57	9.33	NA	8.27	9.98	8.49	10.16
JULY	**NA**	**NA**	**NA**	**NA**	**8.14**	**9.88**	**8.43**	**10.04**

SELECTED SECURITIES

		PRIME COMMERCIAL PAPER	U.S. GOVERNMENT				
1990	FEDERAL FUNDS RATE	(3-Month)	6-Month	1-Year	3-Year	10-Year	A-Rated Utility
APR	8.26%	8.30%	7.84%	8.40%	8.78%	8.79%	10.09%
MAY	8.18	8.25	7.76	8.32	8.69	8.76	10.04
JUN	8.29	8.14	7.63	8.10	8.40	8.48	9.85
JULY	**8.15**	**7.99**	**7.52**	**7.94**	**8.26**	**8.47**	**9.96**

CURRENT SECONDARY MARKET YIELDS

1990	GNMA[3]	FNMA[3]	FHLMC[3]
APR	10.01%	9.94%	9.94%
MAY	9.99	9.93	9.92
JUN	9.73	9.73	9.72
JULY	**9.66**	**9.66**	**9.66**

SPREADS
(Basis Points)

1990	GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
APR	122	115	115
MAY	123	117	116
JUN	125	125	124
JULY	**119**	**119**	**119**

SECONDARY MARKET ACTIVITY
(Dollars in Millions)

	FNMA				FHLMC*				GNMA	
	Portfolio		Mortgage-Backed Securities						Pass-Through Securities	
1990	Commitments**	Purchases	Outstanding	Issued	Commitments To Sell	Commitments To Buy	Mortgages Purchased	PCs Issued	Applications	Issued
MAR	$1,754	$1,945	$246,391	$8,339	$7,061	$6,118	$6,301	$6,502	$5,274	$4,930
APR	1,568	1,705	252,236	7,790	7,211	10,441	5,719	5,687	1,667	4,477
MAY	1,960	1,630	257,218	7,081	5,093	8,502	6,064	5,792	6,923	4,993
JUN	**2,089**	**1,802**	**263,330**	**8,266**	**NA**	**NA**	**NA**	**NA**	**6,851**	**5,674**
1989 TOTAL	27,409	22,518	---	69,764	85,408	86,263	78,589	73,518	60,149	57,522
1988 TOTAL	23,435	23,110	---	54,878	41,271	70,669	44,075	39,777	58,578	56,531
6 MONTH AVG. 1990	1,787	1,806	---	7,868	6,378	7,801	6,037	6,308	4,905	5,099
1989	1,955	1,309	---	4,778	5,633	6,845	5,210	4,875	3,947	4,119
1988	2,578	2,265	---	4,082	2,429	5,148	2,808	2,230	4,146	3,942

*FHLMC year to date averages are one month behind.
**Does not include standby commitments issued, but includes standby commitments converted.

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
1990	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
APR	1,216	951	265	1,108	870	238	124	284	469	339	120	238	423	327
MAY	1,206	933	273	1,065	853	212	127	256	487	336	124	218	410	313
JUN	1,179	922	257	1,108	844	264	114	238	534	293	121	224	428	335
JULY	**1,148**	**905**	**243**	**1,079**	**834**	**245**	**108**	**225**	**498**	**317**	**108**	**227**	**430**	**314**
1989 TOTAL	1,376	1,059	318	1,338	999	340	179	266	536	396	179	252	505	402
1988 TOTAL	1,488	1,140	348	1,456	1,070	386	235	274	575	404	230	266	544	416
7 MONTH AVG. (SAAR)														
1990	1,302	1,013	289	1,233	927	306	143	278	516	363	140	276	460	356
1989	1,429	1,084	345	1,344	998	346	201	272	555	401	189	254	508	393
1988	1,472	1,129	343	1,429	1,055	374	261	268	563	380	250	261	530	389

HOME SALES

(Units in Thousands)

	EXISTING HOMES			NEW HOMES		
1990	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate	Sold (SAAR)	Available for Sale	Months Supply At Current Sales Rate
MAR	3,400	2,340	8.2	558	363	7.7
APR	3,330	2,660	9.6	526	363	8.4
MAY	3,300	2,740	9.9	538	358	8.2
JUN	**3,340**	**2,640**	**9.5**	**581**	**352**	**7.5**
1989 TOTAL	3,440	---	---	650	---	---
1988 TOTAL	3,594	---	---	676	---	---
6 MONTH AVG. (SAAR)						
1990	3,382	---	---	570	---	---
1989	3,443	---	---	632	---	---
1988	3,448	---	---	665	---	---

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

	Total[1]	1–Unit	2+ Units	Nonresidential
MAR	$316.3	$114.3	$18.2	$95.6
APR	313.8	109.7	18.7	94.7
MAY	309.0	105.7	19.0	93.5
JUN	**308.9**	**102.0**	**19.0**	**97.2**
1989 TOTAL	308.5	108.3	20.7	96.0
1988 TOTAL	314.4	112.0	21.4	93.5
6 MONTH AVG. (SAAR)				
1990	311.7	109.3	18.6	95.2
1989	313.6	111.7	21.3	96.7
1988	314.8	111.8	21.7	93.7

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit
(Dollars in Millions)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[5]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[5]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies	Total[5]	Mortgage Bankers	Savings & Loans[7]	Commercial Banks	Life Companies
1989 DEC	$31,039	$5,555	$13,859	$10,951	$325	$3,706	$592	$1,371	$1,076	$333	$17,570	$11	$1,053	$12,970	$3,251
1990 JAN	34,012	9,802	11,023	12,578	247	3,228	866	884	777	377	17,223	149	765	12,928	3,139
FEB	30,279	9,867	9,938	10,129	27	3,042	682	804	768	551	14,041	202	883	9,469	3,320
MAR	**30,572**	**8,703**	**9,445**	**12,014**	**29**	**2,395**	**557**	**750**	**802**	**61**	**18,892**	**102**	**907**	**14,794**	**2,978**
1989 TOTAL	352,026	65,606	157,676	123,193	1,443	31,145	4,443	13,469	7,669	2,786	149,950	1,688	14,476	106,424	25,675
1988 TOTAL	383,566	85,307	188,871	101,863	3,331	38,158	4,526	20,551	6,920	3,732	181,604	1,032	24,368	124,106	29,986
3 MONTH AVG. 1990	31,621	9,457	10,135	11,574	101	2,888	702	813	782	330	16,719	151	852	12,397	3,146
1989	26,271	5,257	12,612	8,041	61	2,643	282	1,433	540	179	10,492	74	1,578	7,243	1,461
1988	24,008	5,940	11,142	6526	79	2,312	234	1,362	386	176	14,155	54	1,967	10,437	1,466

MORTGAGE INSURANCE
(Units in Thousands, Dollars in Millions)

	APPLICATIONS RECEIVED (Units)				LOANS INSURED							
	TOTAL	FHA[8]	VA	PRIVATE	TOTAL		FHA		VA		PRIVATE	
					Units	Amount	Units	Amount	Units	Amount	Units	Amount
1990 MAR	158	99	18	41	113	$8,769	68	$4,442	19	$1,538	26	$2,789
APR	149	88	16	45	110	8,601	65	4,267	15	1,157	30	3,177
MAY	155	93	17	45	112	8,919	65	4,382	15	1,236	32	3,301
JUN	**150**	**90**	**17**	**43**	**113**	**9,021**	**64**	**4,289**	**16**	**1,309**	**33**	**3,423**
1989 TOTAL	1,687	990	194	503	1,274	95,956	726	45,893	183	12,946	365	37,117
1988 TOTAL	1,755	949	211	595	1,334	98,012	699	42,577	211	15,771	424	39,664
6 MONTH AVG. 1990	145	88	17	40	112	8,701	66	4,314	17	1,339	29	3,048
1989	134	79	15	40	99	7,473	56	3,555	16	1,198	27	2,720
1988	155	87	17	51	106	7,634	55	3,298	17	1,240	34	3,096

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1]Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[4]Effective rate on loans closed.

[6]Securities for 0- to 30-day delivery.

[5]In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.

[9]In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[7]Savings & Loans and Mutual Savings Banks.

[8]FHA applications received includes the Direct Endorsement Program.